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PORTUGUESE BANKS AND THE ECONOMIC ADJUSTMENT PROGRAMME: BALANCE SHEET ADJUSTMENTS AND IMPACT ON PROFITABILITY

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Abstract

This thesis studies the different strategies and initiatives followed by Portuguese banks to achieve the targets set by the economic adjustment programme and their impact on the banking sector's profitability. I analyse what banks have undertaken in terms of capital level and other sources of financing. I also address the issue of deleveraging by studying the evolution of the loan portfolio as well as risk weighted assets. Finally, I analyse the impact of those changes on the bank's net interest incomes and cost to income ratio. Using a sample composed of four major Portuguese banks, I conclude that banks have become safer but still need to make some effort to achieve stability.

Key Words: Economic Adjustment Programme; Banks; Deleveraging; Portugal

Introduction

Portuguese banks, as opposed to many other European banks, managed the first part of the crisis pretty well mainly because of their lack of exposure to toxic assets such as subprimes (European Commission, 2011). However, the Portuguese banking system had some major weaknesses that made it vulnerable later on in the crisis. First of all, it had a very weak liquidity position, being too dependent on wholesale and interbank borrowing with an average loan-to-deposit ratio of 160% until mid-2010 (European Commission, 2011), much higher than the European Union average. Furthermore, the proportion of real estate and mortgage loans, as a percentage of total credit outstanding, was high and Portuguese families were extremely indebted, making loans to that sector very vulnerable. In 2010, total outstanding residential loans amounted to 66.2% of the Portuguese GDP (European Mortgage Federation, 2013). The other major weakness lies in their increasing exposure to sovereign risk, 4.1% of the total assets in January 2011 (Banco de Portugal, 2011). Therefore, financial markets had poor expectations on the sustainability of public finances which led to a strong increase in risk premium on sovereign debt. This had negative repercussions on the Portuguese banking system's access and funding costs in the international wholesale debt markets (Banco de Portugal 2010). In this context, Portuguese banks were, therefore, facing restrictions on access to interbank money market financing, which led to a worsening in their liquidity situation (Banco de Portugal, 2010).

In April 2011, the Portuguese government, saw a significant decline in its credit rating to below investment grade, making it impossible for banks to fully rediscount Portuguese sovereign debt at the European Central Bank, negotiated with the Troika (European Commission, European Central Bank and IMF) an Economic Adjustment Programme, covering the period from 2011 to 2014 consisting of a financial package of up to 78 billion euros for potential fiscal financing needs and support to the banking system. One of the programme's objective was the stabilisation of the financial sector (European Commission, 2011). In order to achieve this goal, the banking sector was asked to work on the four following pillars (Banco de Portugal, 2012): reinforcing the solvency of the banking system, promoting a gradual an orderly deleveraging of the banking system and ensuring the stable funding of the banking system, reinforcing the supervision of the banking system and strengthening the regulatory framework.

For the purpose of this work, I will only focus on the two first pillars. As far as the first pillar is concerned, Portuguese banks were required to achieve a Core Tier 1 ratio of 9% by the end of 2011 and of 10% by the end of 2012. As far as the deleveraging of the banking system is concerned, banks were asked to reduce their tremendously high credit-to-deposit ratio to 120% by the end of 2014.

The objective of the paper is to identify what strategies and initiatives the four major Portuguese banks (Espirito Santo Group, Banco BPI, Caixa Geral de Depósitos and Banco Comercial Português) have undertaken in order to achieve those two targets. The study will cover different aspects such as capital requirements, risk weighted assets and banks business models. Once key trends are identified, the paper will go further into the impact of those changes on banks profitability and risk profile.

The work is divided up as follows: section II presents the literature review of the subject, section III presents the strategy followed by banks, section IV explains the impact of the strategies on the banks profitability and section V summarizes the main issues and concludes.

Literature review

Following the goals set by the adjustment programme, banks are required to have a Core Tier 1 ratio of 9 per cent by the end of 2011 and of 10 per cent by the end of 2012.

The Core Tier 1 measure is *"based on the Basel III rules applicable in 2013 for the definition of Common Equity Tier 1, i.e. prior to the application of the transitory regime for certain deductions. In particular, it does not include the deduction for investments in financial institutions which do not consolidate, nor the deduction for deferred tax assets*" (Banco de Portugal, 2012).

In order to reach capital requirements, banks can work on the two sides of the division. Banks can deleverage either by recapitalising or by reducing risk weighted assets, with different economic consequences (Vause et al., 2012). Working on the numerator would imply managing capital, raising new capital, retaining profits/dividends and margin growth and working on the denominator would imply selling assets, managing risk weighted assets, deleveraging and changing business models.

Impact on Profitability

At the time of the implementation of the adjustment programme, Portugal was entering a deep recession, which resulted in the deterioration of the borrowers' credit quality (Banco de Portugal, 2011). With frozen wholesale markets and a steep increase in bond yields, banks were and are still facing an increasing cost of financing combined with deteriorating asset values. Banks more exposed to mortgages have difficulty in impacting a higher cost of funds on the rate charged to existing clients.

Banks are currently facing an environment with lower returns on capital and slower growth. Higher capital requirements primarily impact areas such as sales and trading, securitizations, securities lending, and OTC derivatives (PricewaterhouseCoopers, 2010).

To counter this decreasing profitability, banks have many options. They might consider restructuring their balance sheet in order to improve the quality of capital and reduce capital needs arising from Basel III's deductions as well as managing more effectively scarce balance-sheet resources. They can also adjust their business-model to create more capital and liquidity efficient business models and products. Along this, they should also rethink the scope and even the viability of specific business lines. All these actions might mitigate up to 40% the decrease in ROE. It is however unlikely that banks will ever reach ROE's with level similar to those achieved before the financial crisis (McKinsey & Company, 2010).

Working on the Capital Side

In order to meet these challenges, banks can align current capital, liquidity-measurement and profit and loss accounting practices with the new regulation. According to the industry's experience with BASEL II, its implementation by banks under IRB (internal ratings) can mitigate about 20% of the effects of higher capital requirements. This might restore up to 0.5% of lost return on equity (ROE). Banks can also restructure their balance sheet. The issues raised by balance sheet restructuring contribute to 40% of the overall ROE impact. Assuming 50% of this can be addressed by actions such as reducing DTAs or optimizing the financial investment and corporate shareholding structure, and by reducing funding cost through an on-going balance sheet management, between 0.5 and 1 percentage point of ROE, can be saved (McKinsey & Company, 2010).

Risk Weighted Assets

With Basel III, RWA optimisation can become more important, since increasing the capital base, which is vital for the survival and growth of banks, is limited (Accenture, 2012).

In the previous decade, banks surprisingly decreased their risk weighted assets as a percentage of total assets, going from 44% to 39% from 2000 to 2010 in Europe and in the United States, and more precisely from 40% to 33% within the same time period in the Eurozone (Accenture, 2012). Changes in business models were observed, with a shift from high to low risk weighted asset activities. Because credit risk accounts for a major part in risk weighted assets, most banks reduced their loan size as a percentage of total assets. Accenture has identified key factors that influence banks' risk weighted assets. The first key driver is a bank's risk profile, which is closely tied to individual choices such as business models as well as macroeconomic and institutional factors. For example, there is a significant correlation between loans as a share of total assets and the density of RWA. Not only does the share of the loan have an impact on RWA but also the credit risk associated with those loans. The business model accounts, on average, for 50% of the total RWA density. The composition of the loan portfolio is also important. Banks with more corporate loans, particularly to small and medium size enterprises, tend to have a higher RWA density (Accenture, 2012).

Since the Basel committee has allowed and encouraged banks to develop their own risk measurement tools, risk management has also become a factor impacting risk weighted assets. The way banks measure credit analysis, monitoring and recovery has a significant influence on the major risk parameters, especially on probability of default and loss given default (Accenture, 2012). However, one should bear in mind that through the use of internal risk assessment methods, larger banks might be able to reduce their RWA without truly mitigating risks. Their internal assessment of the required capital charges might be biased downwards (Ayadi et al, 2012).

Deleveraging

The effects of further debt reduction and deleveraging in the financial sector depend on how it takes place. An increase in equity, if feasible, is an expensive solution but on the other hand, if deleveraging is undertaken by reducing assets, especially loans to the non-financial sector, to well below demand by households and businesses, this would cause a credit crunch with serious adverse consequences for growth (Bouis, 2013).

Some economists are stating that banks are too big nowadays and that deleveraging should be undertaken until banks cut all their non-core business lines (Wehinger, 2012). As from 2011, European banks, therefore, sold large volumes of assets, especially high risk weights assets such as low-rated securitised assets, distressed bonds and commercial property and other risky loans. They also sold assets with market prices close to holding values (Vause et al., 2012). French and Spanish banks sold dollar-funded assets and foreign operations to focus only on their core activities and a lot of UK banks decreased the size of their balance sheet. Industry experts estimate that European banks will dispose of about 0.5 to 3 trillion euros in the coming years (Bank for International Settlements, 2012).

Changes in Business Models

Banks can also review their business models and see which business segments will remain profitable with the new regulations (McKinsey & Company, 2010). Banks need to rethink their portfolio strategy with particular attention to how the new capital, liquidity, funding and leverage requirements affect each segment and product. They might redesign products to ensure client needs while optimizing the bank's capital and liquidity, for example by focusing on capital light products such as the use of factoring instead of receivables which reduce their RWA by nearly half. Other strategies can be the use of product bundles that combine financing and deposits, special offers to attract stable funding in the form of retail and SME deposits, increasing the proportion of short-maturity lending to reduce funding costs (more revolving loans, less corporate mortgages) (McKinsey & Company, 2010).

Changes might also be made on the customer side, with a higher focus on customer's segments that generate higher returns. To see if a segment is attractive or not, banks will consider not only segment growth and economics but also the required capital and funding to serve the segment. On the other hand, banks will probably cut some client segments that account for a big RWA share and do not generate enough return (especially in the corporate sector). A high focus will also be given on clients that have a low-default rate. Banks are likely to convert a part of their clients' investment portfolio into deposits. (McKinsey & Company, 2010).

Banks can also focus on geographical distribution, in order to find a solution that minimizes capital and funding requirements (McKinsey & Company, 2010).

Finally, banks should consider the future profitability of their existing businesses given the new regulatory framework and different mitigation solutions. They can try to find ways to modify prices and cut costs in order to remain profitable. If it is not sufficient, they might want to consider exit strategies for some of their business lines, even if that implies a significant reduction of their total volume of activity (McKinsey & Company, 2010).

Bank's strategies after the crisis

This section is dedicated to the analysis of the strategy followed by the four major Portuguese financial groups to achieve the objectives set by the adjustment program. The analysis is based on data taken from the four banks annual reports (2005 to 2013).

Espirito Santo Group

Target Ratios

Espirito Santo's loan to deposit ratio stood at 192% in 2009 and has been gradually decreasing every year since, reaching 121% at the end of 2013, close to the 120% threshold imposed by the economic adjustment program for the end of 2014. Core tier 1 ratio, which was 8% in 2009, increased and reached 10.6% at the end of 2013. Appendix 1 shows the evolution of those ratios throughout the years.

Capital

In order to comply with the core tier 1 ratio target, BES undertook several actions to increase its share capital. In December 2011, they concluded a debt to equity exchange, raising 530 million in capital. In May 2012, they raised about 1,009 billion euros in capital through the successful issue of about 2,556 billion shares. Appendix 2 summarizes Espirito Santo capital level throughout the years. Share capital therefore increased by 44% between 2010 and 2013, leading the equity to account for 8.75% of total sources of financing in 2013, which is globally more than in the nine previous years. The need to raise capital was a necessity, not only to comply with capital ratios, but also to cover the losses they were facing. In 2011, because of huge amounts of loans and other assets impairments, BES's net income decreased drastically and was even negative in 2013.

Sources of Financing

A strong focus has been set on increasing deposits, through the acquisition of new clients. BES strengthened the cross-sell of its insurance and banking solutions via Companhia de

Seguros Tranquilidade, the life insurance company held by Espirito Santo Group. They have also launched marketing campaigns as well as innovative savings solutions that allow customers to save as from a minimum of 10 euros a month. Deposits therefore increased by 19.51% between 2010 and 2013, going from 30.919 billion euros to 36.831 billion (Appendix 3). In 2009, they accounted for as low as 30.92% of the total source of financing and gradually increased since then. In 2013, they accounted for 45.69%, a level almost similar to 2004.

As far as other sources of financing are concerned, there has been an increasing reliance on deposits from central banks (mostly European Central Bank) which accounted for 11.82% of the total sources in financing in 2013 whereas it accounted for only 1.16% ten years ago. This increase was particularly marked in 2010 and 2011 and stable after, the objective being, indeed, to mitigate this dependence. The share of debt securities and subordinated debt decreased a lot reflecting the high difficulty of Portuguese banks to borrow on capital markets. Debt securities, which accounted for as much as 40.22% in 2009, represented only 14.79% of total sources of financing in 2013.

Loan portfolio

Espirito Santo decided to run a deleveraging programme mid-2010, before being forced to do so by the economic adjustment program. They first cut loans, especially international loans in order not to harm the Portuguese economy. On a global scale, the gross loan portfolio decreased by 5.5% between 2010 and 2013. This fall was first due to a sharp decrease in corporate loans, which represent about 73% of the loan portfolio. However, since 2011, mortgage loans and other loans to individuals have decreased a lot more. The evolution of the loan portfolio throughout the years is shown in Appendix 4. This decrease is due to the following facts: first of all, loans were sold with priority set on international loans. However, the international loan portfolio decreased from 2010 to 2011 but increased after 2011. The reduction operated as from 2010 came only from domestic loans: by the end of 2013, BES indeed sold about 3 billion of those loans on markets. Secondly, BES was more selective when granting new loans. More guarantees were required and they looked for higher quality loans. Finally, one should bear in mind that the contraction of the loan portfolio is also due to a decreasing demand for loans, especially for mortgages and other types of individual loans (consumption loans etc.), because of the economic conditions.

Risk Weighted Assets

Along with its capital increase, BES also undertook a decrease of the risk weighted assets which decreased from 68.802 billion in 2010 to 57.492 billion in 2013 i.e. a 16.44% decrease (Appendix 6). To perform this drastic reduction, BES had to cut some loans and business lines. In 2011, they reached an agreement to sell their share capital of the subsidiary in the United Kingdom, ESAF alternative asset management and also sold securities portfolio for an amount of 1.7 billion. In 2013, they sold most of their stake in EDP, the major electricity provider of Portugal. In 2012, they acquired 50% of the shares of BES Vida. In general, acquiring an insurance business has a positive impact on core Tier 1 ratio since it brings steady cash flows and it is not very risky. The total amount of assets however remained quite stable (a small decrease of 2.05% from 2009 to 2013), which means that the reduction in risk weighted assets came from a recomposition of assets. Loans to customers accounted for 57.48% of total assets in 2013 whereas they accounted for 59.51% of the total assets in 2009 and 61.41% in 2010. On the other hand, there has been an increase in the weight of current and non-current assets held for sale.

Assets held for sales are valued at market price, which means that losses are already recognised.

Banco BPI

Target Ratios

BPI's loan to deposit ratio was 131.7% and has been gradually decreasing every year since then, reaching 96% at the end of 2013. Attention should be paid to the fact that this relatively low loan-to-deposit ratio is due to the extremely low loan to deposit ratio of the international activity (20.5% in 2012). In Portugal, in 2012 for example, loan-to-deposit ratio was still 129.2%. Core tier 1 ratio which was 7.8% in 2009 was well managed and stood at the end of 2013 at a 16.5% level. Appendix 6 shows the evolution of the target ratios throughout the years.

Capital

Share capital increased only once since the crisis: 200 million euros raised by shareholders in 2012. In addition to that, BPI also issued a 1.500 million euro in contingent convertible subordinated bonds (CoCo's) with a five year maturity, subscribed for by the Portuguese state in June 2012. CoCo's are hybrid capital instruments. It is a debt that absorbs losses and therefore becomes equity when capital fall under a certain level. They issued it in order to comply with the sovereign debt buffer imposed by the EU and the ECB to cover their exposure on Portuguese and Greek sovereign debts. BPI immediately reimbursed 200 million thanks to the capital increase they made in 2012. In 2013, they reimbursed an additional 280 million euros. This early reimbursement allowed them to get rid of the high interest costs associated with this hybrid capital instrument.

Equity increased as from 2012, thanks to the 2012 profit as well as to the positive change in fair value reserve, linked to the increase in public debt bonds value and an increase value of the portfolio of financial assets available for sale. As a percentage of total sources of financing, equity has remained constant throughout the years, between 4 and 5% during the nine previous years. Consolidated net income was negative in 2011 because of large impairments on their Greek debt but was positive during the two following years, which is probably why they didn't try to raise share capital at any cost.

Sources of financing

The bank has striven to increase customer deposits and it actually increased from 14.56% for the period going from 2009 to 2013. The biggest increase was in 2011 (7%). (Appendix 8) However, there is no particular strategy to increase customer deposits mentioned in BPI's annual reports. As a percentage of total sources of financing, deposits have slightly increased, reaching 59.71% in 2013. As far as other sources of financing are concerned, we can see the increasing weight that resources from central banks has taken and the decreasing weight of debt securities and even subordinated debts.

Loan Portfolio

The size of the loan portfolio decreased, due to the higher selectivity in granting loans, higher spreads on new loans (because of the higher funding costs on the Portuguese market) but also a smaller demand due to the economic conditions. BPI even had the objective of reducing the loan portfolio by 1 billion euros, by cutting corporate, institutional, as well as project finance's loans. Therefore, domestic corporate banking loans decreased by 25.66% from 2010 to 2013. As for Banco Espirito Santo, BPI strategy kept focusing on lending to Portuguese SME's, especially exporting companies. Appendix 9 summarizes the evolution of BPI's loan portfolio.

The share of international loans decreased from 21.42% in 2009 to 14.06% in 2013, reflecting BPI's willingness to cut international loans in order to limit their impact on the Portuguese economy.

As a percentage of assets, loans and advances from customers represented only 60.81% of total assets in 2013, which is the lowest figure of the nine previous years.

Risk Weighted Assets

BPI increased its financial advisory activity, mainly in the health, infrastructure and transportation sectors. Assets under management decreased, partly explained by the transfer of retirement-pension to the social security system (pension fund assets worth 1.373 billion euro). BPI also focused on the sale of insurance, business with lower risks and high commissions, through their 35% in Allianz Portugal, the Portuguese branch of the insurance world leader. Risk weighted assets declined from 26.0358 billion in 2009 to 21.0160 billion in 2013, a 19.26% decrease, with the highest year to year decrease being from 2012 to 2013 (-14.26%) (Appendix 10).

Another trend in the asset side is the increasing share of financial assets held for sale in BPI's total assets that accounted for 22.70% of the bank balance sheet in 2013, reflecting the priority given at selling financial assets to decrease risk weighted assets and capital requirements.

Caixa Geral de Despositos

Targets Ratios

Caixa Geral de Depositos' loan-to-deposit ratio was at a 133.6% level in 2009 and even at a 136.0% level in 2010. The bank then began a deleveraging process and the loan-to-deposit ratio quickly decreased reaching a 103.6% level in 2013. As far as capital ratios are concerned, core tier 1 ratio was 8.30% in 2009 and increased year by year to reach 11.5% in December 2013 (Appendix 11).

Capital

In order to achieve the capital ratio requirements, CGD increased its share capital by 100 million in 2011 (through incorporation of reserves) and by 750 million in 2012 (through the Portuguese state who is its sole shareholder). Share capital evolution is shown in Appendix 12. Another reason why the need to raise capital was strong is the losses the bank was constantly reporting on the balance sheet as from 2011, due to very high level of loan impairments. In addition to that, they raised 900 million by issuing Coco's, which is also considered as being part of the Core Tier 1 capital. The Portuguese state subscribed to the 900 million issue. Equity, as a percentage of total sources of financing, has not increased much in the previous years.

Sources of financing

Customer deposits increased from 60.209 billion in 2010 to 67.623 billion in 2013, a 12.31% increase (Appendix 13). In order to achieve this growth, CGD has broadened its savings offers, strengthened by strong marketing and communication campaigns. The CGD's international business has contributed the most to this growth. Indeed, deposits outside Portugal increased by 47.47% from 2010 to 2013 whereas in Portugal they only increased by 5.37% within the same time period and even decreased between 2012 and 2013(Appendix 13). International deposits accounted for 16.45% of total deposits in 2010. Thanks to their high growth, they accounted for 21.60% of total deposits in 2013. Customer resources (including deposits) accounted for 60.04% of total sources of financing in 2013, whereas they only accounted for 53.11% four years before. As far as other sources of financing are concerned, there is an increasing dependence on resources from central banks (5.35% of total sources of financing in 2009 and 11.61% in 2010, the ratio stabilized after) and a big decrease in debt securities as a percentage of total sources of financing (20.81% in 2009 and only 7.78% in 2013).

Loans

The loan portfolio decreased by 11.8% between 2010 and 2013. The contraction of the loan portfolio corresponded first to a decrease in the international loan portfolio but in the two following years the Portuguese sector was also affected by this loan. Despite its relatively small contribution to the loan portfolio (2.6% of the domestic loan portfolio in 2010), it should be mentioned that loans to individuals except mortgage loans (car financing, credit for consumption …) were drastically reduced between 2010 and 2013 (-32.51%). The share of international loans decreased slightly over the years. Appendix 14 shows the evolution of CGD's loan portfolio throughout the years.

Risk Weighted Assets

In 2011, CGD Group decided to increase its capital base, to reach the level required by the economic adjustment program. In order to do so, they focused on increasing deposits, selling their insurance business as well as their non-core assets and decreasing the volume of their international activity. CGD's long term goal is to transform their business model, with a focus on services that depend less on net interest income. They want to become a multinational group focused on their banking business, lending mainly to export companies and taking savings from customer and corporate sectors, whereas they were, at that time, a highly diversified financial group. An example of non-core assets sale is the sale of its 6.1% equity stake in Portugal Telecom in November 2013. In the composition of assets, there were however no major change, the share of loans and advances to customers remained more or less stable as from the beginning of the adjustment program (63.83% in 2009 and 62.03% in 2013). There was a slight increase in the financial assets available for sales, reflecting CGD's strategy to sell non-core activities.

Millennium BCP

Targets

Millennium BCP reached a core tier one capital ratio of 13.8% at the end of 2013, from 6.7% in 2010 (Appendix 19). As far as loan-to-deposit ratio is concerned, they reached a

117% loan-to-deposit ratio at the end of 2013, slightly under the 120% threshold fixed by the economic adjustment programme for the end of 2014. In 2010, prior to the implementation of the programme, BCP's loan-to-deposit ratio was 164% (Appendix 15).

Capital

Share capital increased in 2011 by 1.371 billion euros, mostly due to an exchange offer against subordinated perpetual securities but also due to the incorporation of issue premium reserves as well as a public offer for subscription. In 2012, 500 million euros were also raised through a public offer but later in 2012, share capital decreased by about 3,065,000,000 euros. Half of this amount was aimed to cover the losses of 2011 and the other half was switched into the reserves to absorb future losses (Appendix 16). The bank, indeed, reported losses from 2011 to 2013. Core Tier 1 capital increased, due to the increase in share capital and in 2012, the reduction in share capital was offset by a 3 billion Coco's issue during the same year.

Equity, however, as a percentage of total sources of financing decreased from 7.56% in 2009 to 3.99% in 2013, because of the reduction in share capital and in preference shares.

Sources of Financing

Deposits increased by 7.57% from 2010 to 2013, even though there was a small decrease between 2012 and 2013(-0.78%) (Appendix 17). A strong focus was set in changing client's savings habits and in attracting new customers through an extension of BCP's savings offer or marketing campaigns such as in 2012 "monthly income deposits", "special one top deposit", "Olympic deposits" or "premium savings", which allowed customers to save as little as 10 euro per month. Cross-selling of BCP's products with Medis Health Insurance was also used to attract new customers.

Customer deposits, as a percentage of total sources of financing increased over the years, reaching 59.70% in 2013, whereas the share of debt securities decreased, reaching an all-time low of 11.48% in 2013. The share of deposits from central banks almost doubled in 2010 but then decreased year after year.

Loan Portfolio

The loan portfolio decreased by 12.5% between 2010 and 2012. Reduction in loans to company contributed a lot to this decrease (-18.32% between 2010 and 2012). Activities in Portugal have suffered from this decrease. In 2010, loans to Portuguese companies and individuals accounted for 77.11% of the total loan portfolio. In 2012, this figure decreased to 74.16%. The reasons for the decrease are first a decrease in demand, both from individuals and companies, due to the worsening of the economic conditions in Portugal and worldwide. Secondly, it comes from BCP's higher selectivity in granting loans as well as a willingness to reduce the commercial gap. Finally, BCP has also sold some loans (more than 1 billion sold in 2012 for example). The evolution of the loan portfolio is shown in Appendix 23.

As a percentage of total assets, loans to customers decreased to 69.27% in 2013, which is also an all-time low, counterbalanced by the increase of financial assets held for sale, reflecting BCP's willingness to decrease the size of its balance sheet.

Risk Weighted Assets

Risk Weighted Assets decreased by 35.60% between 2010 and 2013, the largest reduction being in 2013 (Appendix 18). This reduction is a mix of several elements. First of all, the deleveraging process undertaken by BCP through loan sales and the reduction of activities had a positive impact on the decrease of risk weighted assets (4.649 billion euros in 2011 and 1.610 billion euros in 2012). The move to the IRB approach for risk weighted assets computations also had an impact; risk weighted assets decreased by 750 million in 2011 thanks to the implementation of IRB method for "Retail Revolving Exposures" and "Other Retail Exposures" and by 294 million euros in 2012 thanks to the change to the IRB method for "loans secured by residential real estate" and for "renewable positions". There were also some smaller positive changes, such as the reduction of risk weights associated with the exposure to sovereign risk in Angola and Mozambique, or the focus on replacing short term loans to companies by factoring. On the other hand, the risk weight associated with the exposure to the sovereign risk of Portugal increased, which had a negative impact on BCP's risk weighted assets (increase of 1,340 million in 2011). BCP undertook a major redefinition of its corporate strategy in which deleveraging had a central role. The following activities will be sold in the following years, which will have a huge impact on the reduction of risk weighted assets: their subsidiary "Millennium Asset Management", the loan book of BCP Cayman Islands and BCP Switzerland, 100% of their equity in Millennium Romania as well as in Piraeus, the bank that acquired BCP's Greek division. This will lead to a big decrease in risk weighted assets. Furthermore, if they are not able to repay their Coco's debt, they also agreed to sell their equity in BCP Poland.

General Trends

At the end of 2013, the four banks reached the targets set by the Troïka, except for Banco Espirito Santo that still has a loans-to-deposits ratio 1% higher than the objective. As far as Core Tier 1, the four banks reached the 10% target.

The banks did increase their capital, raising money via the capital market for BES, BPI and BCP and via the Portuguese state for CGD. Increasing capital was even more important since they were reporting losses that needed to be absorbed by capital. For BPI, BCP and CGD, raising money through capital markets was not enough to comply with the requirements and they used Coco's as a way of reaching those targets. However, this was only punctual, the focus of the four banks to reach capital ratios was indeed to decrease risk weighted assets more than increasing capital, especially since Coco's are extremely expensive. Therefore, they sold foreign subsidiaries and some equity stakes they had in non-banking companies.

The loan portfolio of all the banks decreased, partly because of loan sales (corporate loans were the most affected), but also due to impairments, a decreasing demand for new loans, due to the poor economic conditions and finally a higher selectivity of the banks to grant new loans.

As far as sources of financing are concerned, there was a strong focus in increasing deposits to have a more stable funding base and decrease the current dependence on central banks. This was done thanks to major marketing campaigns, cross-selling of products as well as launching of new savings solutions designed for customers that were not used to saving. Customer resources as a percentage of total sources of financing therefore increased and reached around 60% for BPI, CGD and BCP whereas for BES it is only 45%. As a result, the share of resources from central banks stabilized after a strong increase at the beginning of the crisis and the share of debt securities decreased. The strategies described above therefore explained how the four banks reached the targets. However, one should be careful when interpreting the loans-to-deposits ratios. The current formula used by banks to compute their loan-to-deposit-ratio is the total loan portfolio of the bank, net of impairment divided by the total volume of deposits of the bank. It is questionable whether using the loan portfolio, net of impairment, is relevant. Indeed, a decrease in the loan-to-deposit ratio might only be the consequence of loan impairments and not of a true contraction of the loan portfolio via sales of loan pools. This might bias the loan-to-deposit ratio downwards. Nevertheless, making loan impairments is very important since it allows the loan portfolio to be freed from some of its wastes.

Profitability analysis

This section analyses the evolution of the four studied bank's profitability once the deleveraging process has been undertaken. Data used for the purpose of the analysis come from the banks' annual reports.

Net Interest Income

Net interest incomes of the four studied banks have tremendously decreased. Between 2009 and 2013, the net interest incomes of BES, BPI, CGD and BCP declined respectively by 13.87%, 23.89%, 43.29% and 36.43% (Appendix 20). Reasons for this huge decrease are numerous and are partly explained by the balance sheet adjustments operated by the banks. As mentioned previously, financial constraints imposed by the economic adjustment program forced banks to separate themselves from some assets which has therefore led to a drastic reduction in interest income. Because of the reduction in assets, interest expenses also went down but not proportionally. The decrease was, indeed, smaller because of the changes in sources of financing operated by banks. They turned to more stable but also more expensive resources such as customer deposits as well as hybrid capital instruments such as Coco's. One should also bear in mind that given the situation of the economy, costs of funding increased, which narrowed the net interest income. Another reason is also the repricing of assets in a context of historically low levels of EURIBOR (Banco Espirito Santo, 2014). Mortgages indexed to EURIBOR gave lower returns.

Other sources of income

As far as other sources of income, such as dividend from equity investments and net commissions perceived, are concerned, there is no clear trend among the four banks. Income from dividends decreased a lot at BES and CGD, because of the sale of equity stakes in companies operated by these two banks.

Cost to Income Ratio

The cost to income ratio is currently in an upward trend, reflecting the decrease in net interest margin and other income for the four studied banks. This put a downward pressure on profitability forcing the banks to take measures that reduce operating costs. The ratio increased respectively by 39.24%, 7.11%, 26.69% and 13.42% for BES, BPI, CGD and BCP between 2009 and 2013 (Appendix 21). Both the operating costs and operating income decreased but the decrease in operating income was bigger, due mainly to a smaller net interest income. As far as operating costs are concerned, they have also globally decreased, due to a decrease in the number of branches and employees, such as for Banco Espirito Santo and BPI.

Profitability of the studied banks is therefore decreasing because of the economic conditions and the adjustments banks had to make to their balance sheets, narrowing the sources of revenue and increasing the cost of financing. Therefore, this led to a decrease in efficiency that the banks are currently trying to offset by a reduction in operating expenses. However, reducing operating expenses cannot be done infinitely and takes more time than it takes to decrease net interest income, which suggests that profitability and efficiency can increase but might never return to their historical pre-crisis levels. It should be noted that the low level of inflation currently in Europe also doesn't help the net interest income increasing and partly explains the low profitability.

Conclusion

In May 2014, Portugal exited its three year bailout. Thanks to the programme, banks avoided a liquidity squeeze: they were able to cover the losses they faced due to high levels of loans and other assets impairments while reaching target ratios imposed by the economic adjustment programme. Those targets have been achieved at the pace of a heavy contraction of the loan portfolio and the search for more stable sources of funding. Today, this deleveraging process is still going on. However, these achievements have to be counterbalanced by the fact that profitability plummeted down. Net interest income is now at historically low levels and with the new structure of Portuguese banks' balance sheets, there is no indication that it will go up in the future. Banks, by selling some loans and business lines have narrowed the sources of revenues and might even have strangled them. One can question whether a low profitability is sustainable on a long term basis and if Portuguese banks are still competitive nowadays. It is difficult to answer the question since a lot of non-recurring operations were done in recent years and other countries are also implementing BASEL III regulations which set similar targets as the one imposed by the adjustment programs. Non-Portuguese banks might, therefore, face the same problems. As far as risk profile is concerned, thanks to the deleveraging process, Portuguese banks are less risky than before. However, even though Portugal is no longer subject to the economic adjustment programme, Portuguese banks need to continue the deleveraging process and get rid of as many bad assets as possible. The Portuguese economy is still fragile, consequently leading to high levels of impairment of loans and other assets. As a result, some banks still have negative net income and still need new capital to cover their losses. Portuguese banks undertook the necessary process to become more stable but there is still a long way to go before they can achieve full financial stability.

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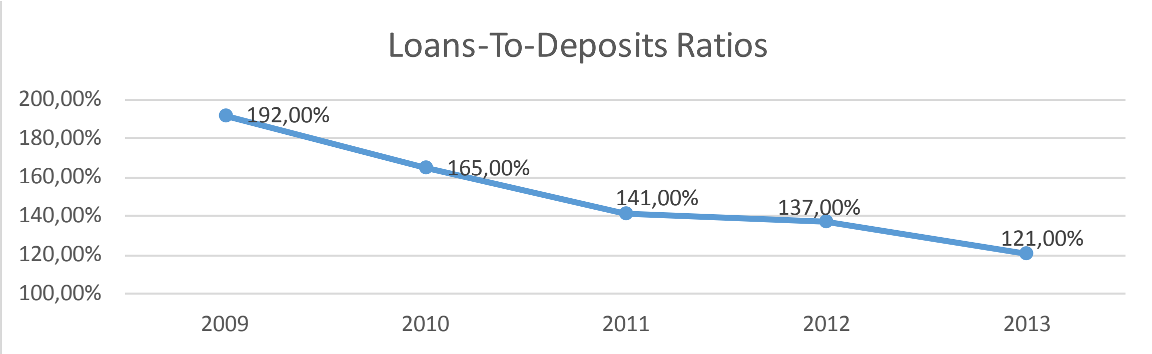
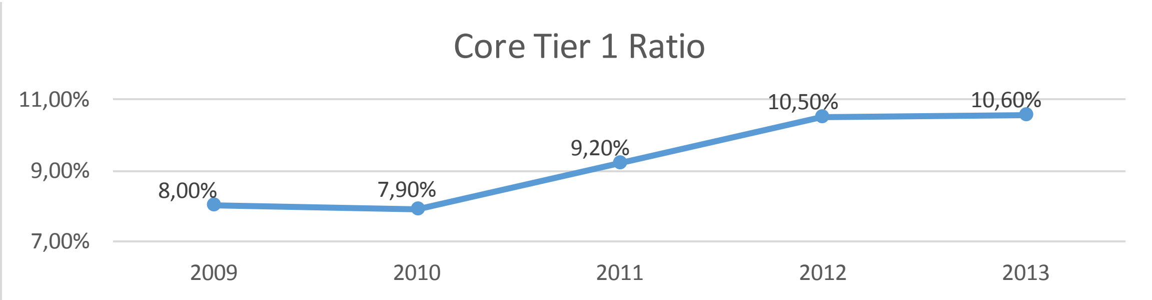
Appendix 1: Targets ratios of Espirito Santo

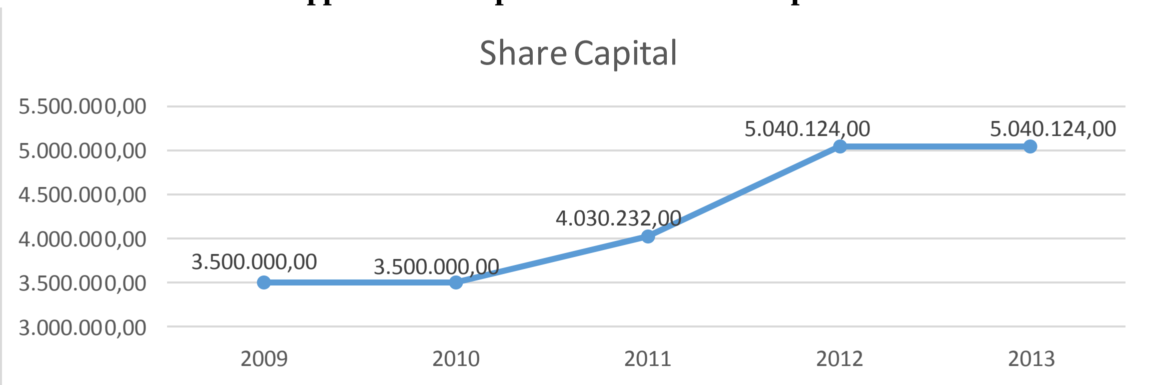


Source: Own source adapted from Grupo Banco Espirito Santo. 2011. “Annual Report 2010”. , Grupo Banco Espirito Santo. 2012. “Annual Report 2011”. ,Grupo Banco Espirito Santo. 2013. “Annual Report 2012”. , Grupo Banco Espirito Santo 2014. “Annual Report 2013”.



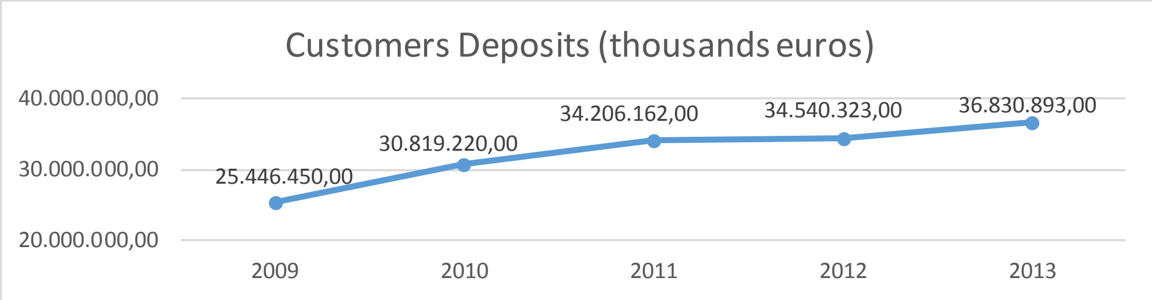
Source: Own source adapted from Grupo Banco Espirito Santo. 2011. “Annual Report 2010”. , Grupo Banco Espirito Santo. 2012. “Annual Report 2011”. ,Grupo Banco Espirito Santo. 2013. “Annual Report 2012”. , Grupo Banco Espirito Santo 2014. “Annual Report 2013”.

Appendix 2: Espirito Santo Share Capital



Source: Own source adapted from Grupo Banco Espirito Santo. 2011. “Annual Report 2010”. , Grupo Banco Espirito Santo. 2012. “Annual Report 2011”. ,Grupo Banco Espirito Santo. 2013. “Annual Report 2012”. , Grupo Banco Espirito Santo 2014. “Annual Report 2013”.

Appendix 3: Espirito Santo Customer's Deposits



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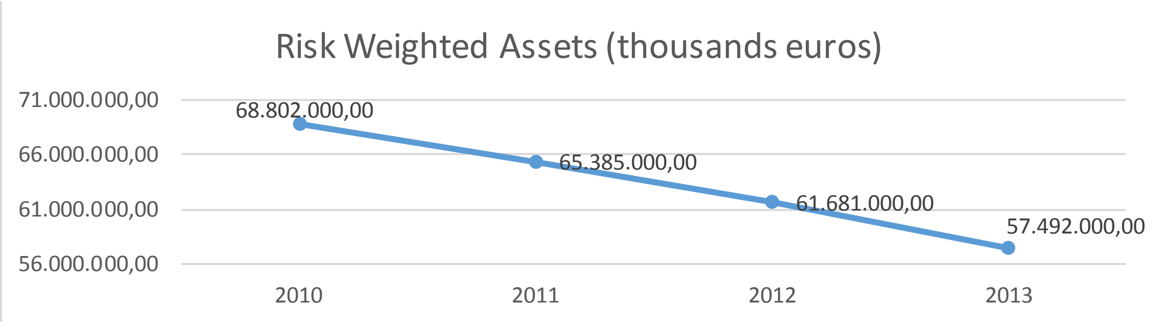
Appendix 4: Espirito Santo's loan portfolio (in thousands euros)

	2009	2010	2011	2012	2013
Total Gross Loan	**53,958,000.00**	**52,606,000.00**	**51,211,000.00**	**50,399,000.00**	**49,722,000.00**
Mortgage	14,779,000.00	11,701,000.00	11,610,000.00	11,133,000.00	10,815,000.00
Individuals	2,817,000.00	2,822,000.00	2,716,000.00	2,628,000.00	2,383,000.00
Corporate	36,362,000.00	38,083,000.00	36,885,000.00	36,637,000.00	36,524,000.00

Source: Own source adapted from Grupo Banco Espirito Santo. 2011. "Annual Report 2010". , Grupo Banco Espirito Santo. 2012. "Annual Report 2011". ,Grupo Banco Espirito Santo. 2013. "Annual Report 2012". , Grupo Banco Espirito Santo 2014. "Annual Report 2013".

Appendix 5: Espirito Santo Risk Weighted Assets



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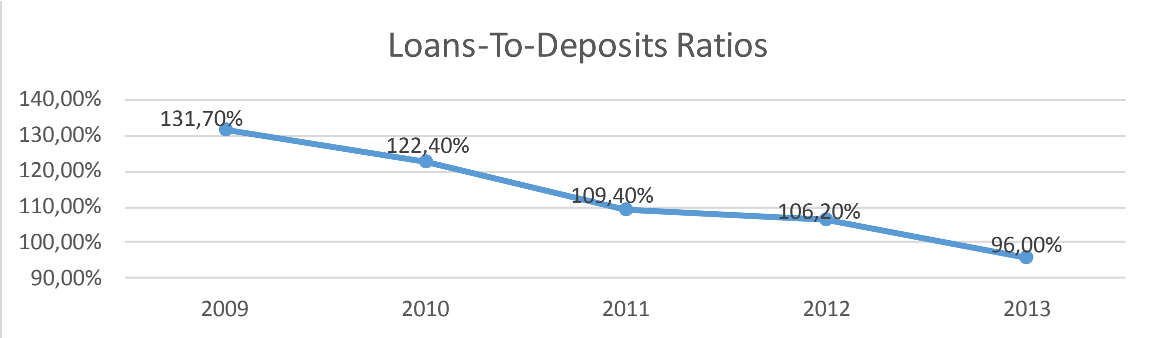
Appendix 6: Target Ratios of Banco BPI



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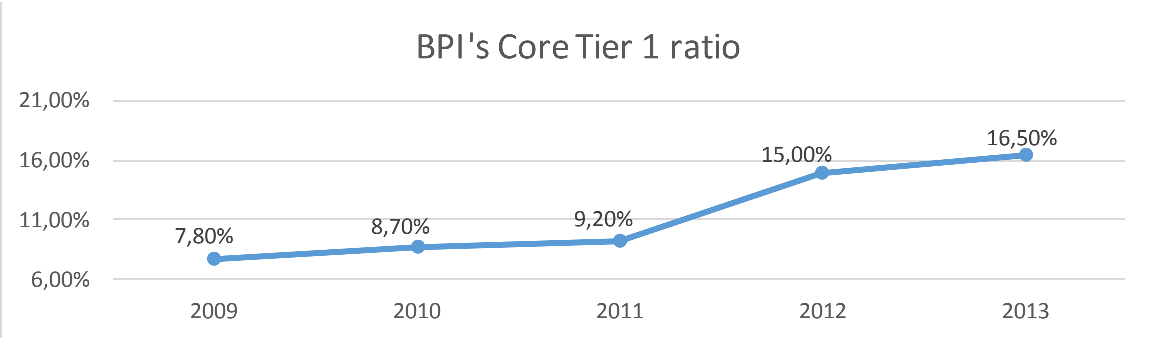

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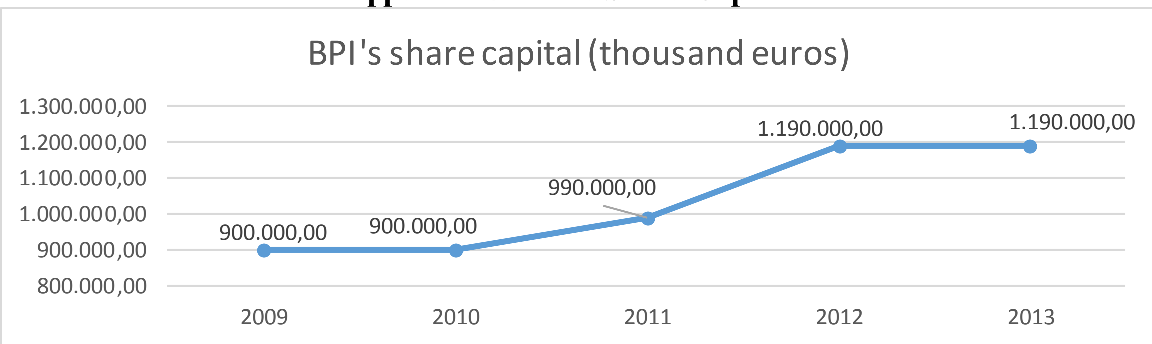
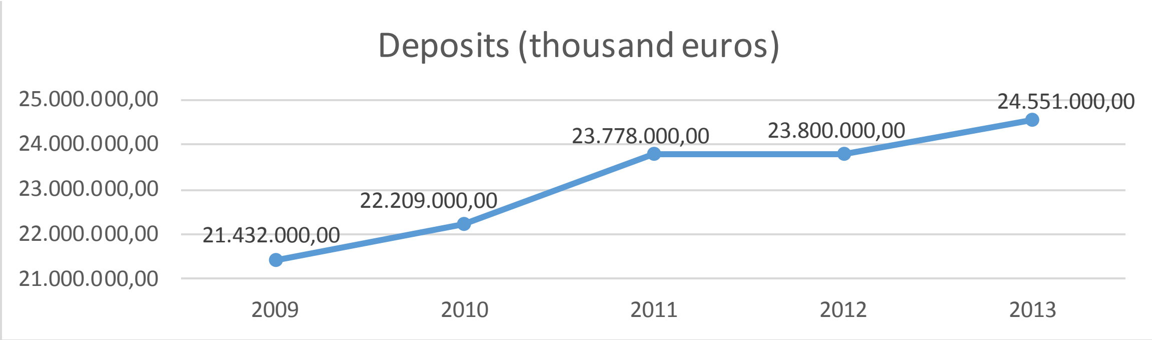
Appendix 7: BPI's Share Capital



Source: Own source adapted from Banco BPI. 2011. "Annual Report 2010". , Banco BPI. 2012. "Annual Report 2011". , Banco BPI. 2013. "Annual Report 2012". , Banco BPI. 2014. "Annual Report 2013".

Appendix 8: BPI's Customer Deposits



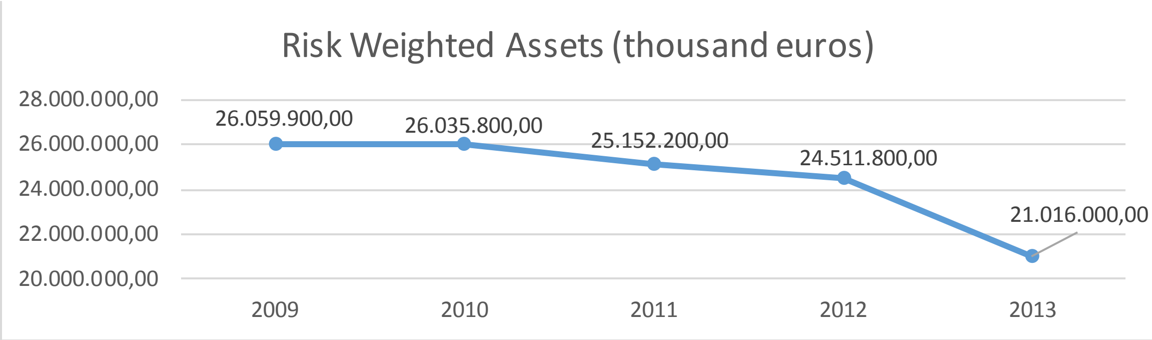
Source: Own source adapted from Banco BPI. 2011. "Annual Report 2010". , Banco BPI. 2012. "Annual Report 2011". , Banco BPI. 2013. "Annual Report 2012". , Banco BPI. 2014. "Annual Report 2013".

Appendix 9: BPI's loan portfolio (thousand euros)

	2009	2010	2011	2012	2013
Total Loan Portfolio (before accrued interests)	22,438,328.00	27,446,409.00	25,601,547.00	24,527,964.00	23,027,758.00
Domestic Loans	17,630,970.00	23,003,811.00	21,919,529.00	21,053,002.00	19,790,515.00
Companies	4,811,297.00	9,664,691.00	8,965,124.00	7,931,346.00	7,184,796.00
Loans to individuals	12,819,673.00	13,339,120.00	12,954,405.00	13,121,656.00	12,605,719.00
Housing	11,113,756.00	11,682,269.00	11,359,068.00	11,743,141.00	11,390,108.00
Consumer	1,022,435.00	1,025,935.00	1,023,766.00	828,012.00	717,098.00
Other loans	683,482.00	630,916.00	571,571.00	550,503.00	498,513.00
Foreign Loans	4,807,358.00	4,442,598.00	3,682,018.00	3,474,962.00	3,237,243.00
Companies	4,341,066.00	3,908,793.00	3,160,308.00	2,930,543.00	2,715,830.00
Loans to individuals	466,292.00	533,805.00	521,710.00	544,419.00	521,413.00
Housing	192,992.00	242,903.00	162,516.00	161,429.00	210,177.00
Consumer	218,097.00	242,009.00	283,484.00	305,101.00	223,910.00
Other loans	55,203.00	48,893.00	75,710.00	77,889.00	87,326.00

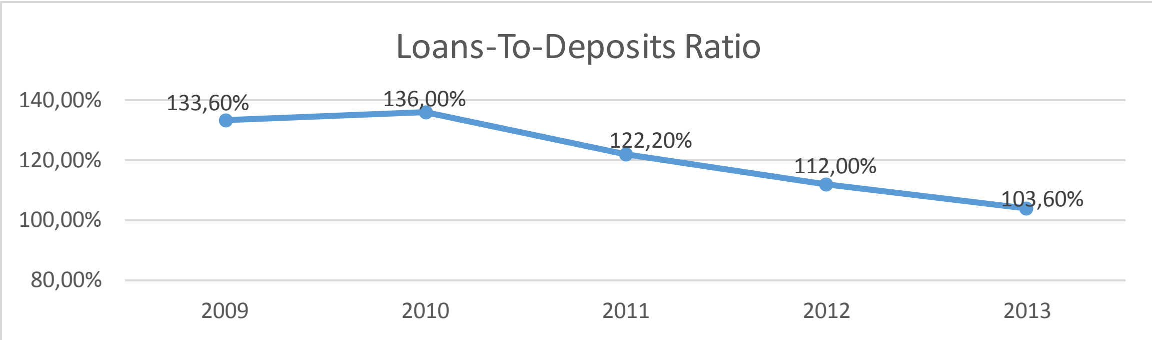
Source: Own source adapted from Banco BPI. 2011. "Annual Report 2010". , Banco BPI. 2012. "Annual Report 2011". , Banco BPI. 2013. "Annual Report 2012". , Banco BPI. 2014. "Annual Report 2013".

Appendix 10: BPI's Risk Weighted Assets

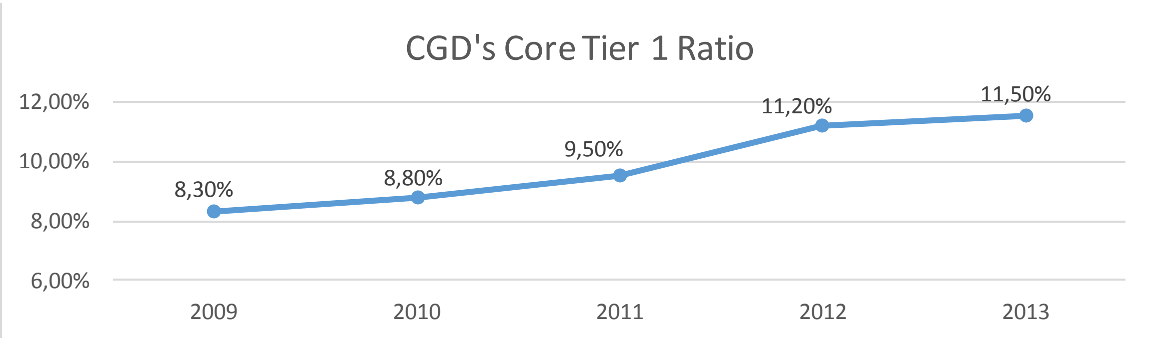


Source: Own source adapted from Banco BPI. 2011. "Annual Report 2010". , Banco BPI. 2012. "Annual Report 2011". , Banco BPI. 2013. "Annual Report 2012". , Banco BPI. 2014. "Annual Report 2013".

Appendix 11: Caixa Geral Target Ratios

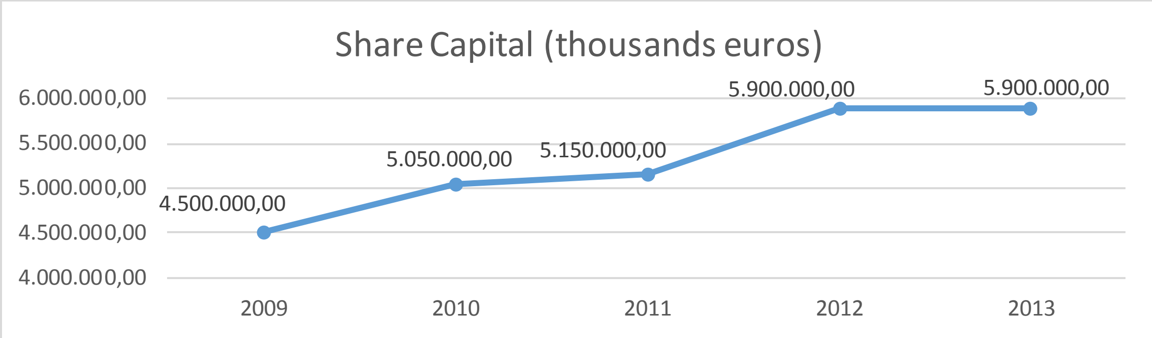


Source: Own source adapted from Caixa Geral de Depositos. 2011. "Financial Statements 2010". , Caixa Geral de Depositos. 2012. "Annual Report 2011". , Caixa Geral de Depositos. 2013. "Annual Report 2012". , Caixa Geral de Depositos. 2014. "Annual Report 2013".



Source: Own source adapted from Caixa Geral de Depositos. 2011. "Financial Statements 2010". , Caixa Geral de Depositos. 2012. "Annual Report 2011". , Caixa Geral de Depositos. 2013. "Annual Report 2012". , Caixa Geral de Depositos. 2014. "Annual Report 2013".

Appendix 12: Caixa Geral Share Capital



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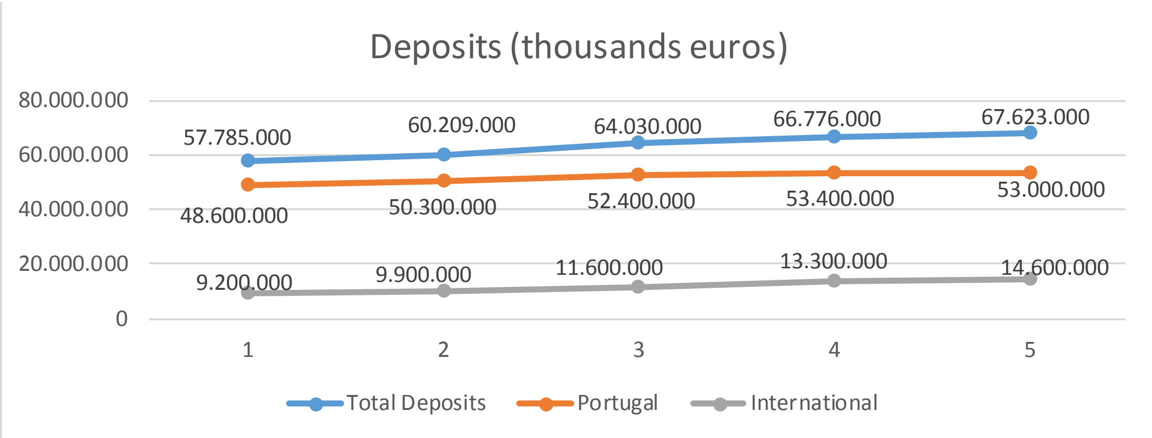
Appendix 13: Caixa Geral Deposits



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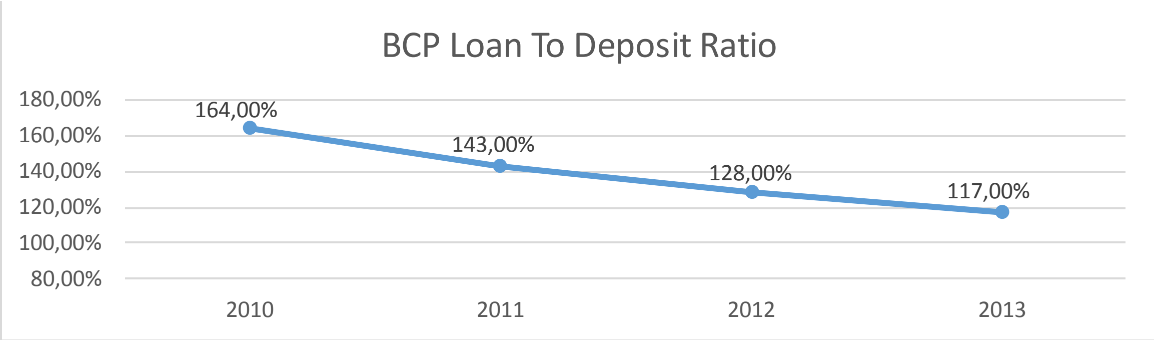
Appendix 14: Caixa Geral Loan Portfolio (in thousands euros)

	2010	2011	2012	2013
CGD operations in Portugal	65,061,000.00	64,382,000.00	61,482,000.00	58,335,000.00
Corporate	24,659,000.00	23,727,000.00	22,770,000.00	21,935,000.00
General government	3,663,000.00	4,333,000.00	3,481,000.00	3,056,000.00
Institutionals and other	1,010,000.00	1,691,000.00	1,983,000.00	1,524,000.00
Individual customers	35,729,000.00	34,631,000.00	33,249,000.00	31,820,000.00
Mortgage loans	34,030,000.00	33,183,000.00	31,957,000.00	30,674,000.00
Other	1,698,000.00	1,448,000.00	1,292,000.00	1,146,000.00
Other CGD Group companies	19,456,000.00	18,151,000.00	17,334,000.00	16,208,000.00
Total	84,517,000.00	81,631,000.00	78,816,000.00	74,542,000.00

Source: Own source adapted from Caixa Geral de Depositos. 2011. "Financial Statements 2010". , Caixa Geral de Depositos. 2012. "Annual Report 2011". , Caixa Geral de Depositos. 2013. "Annual Report 2012". , Caixa Geral de Depositos. 2014. "Annual Report 2013".

Appendix 15: Target Ratios of BCP



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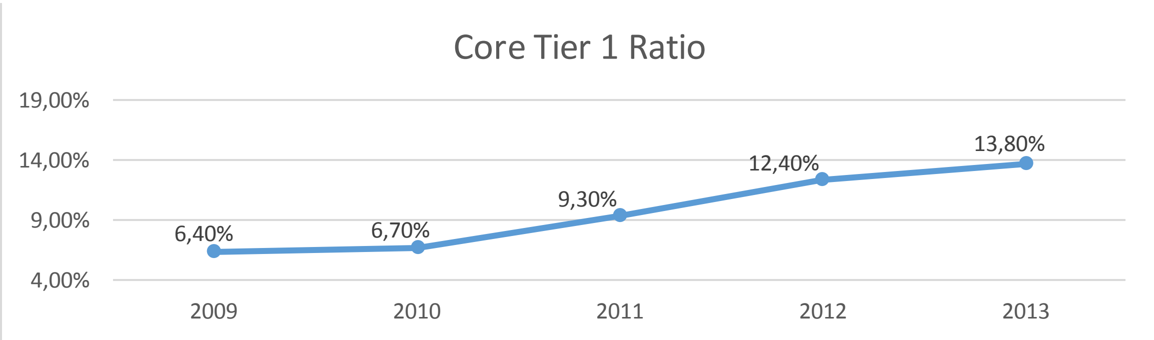

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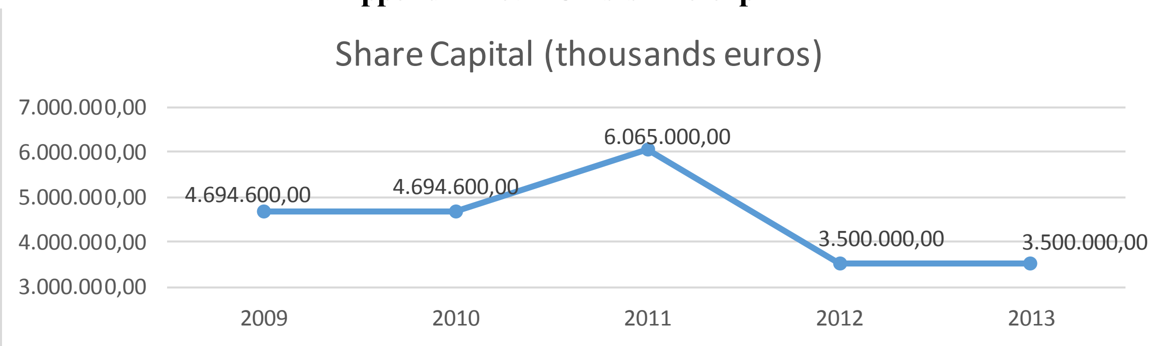
Appendix 16: BCP's share capital



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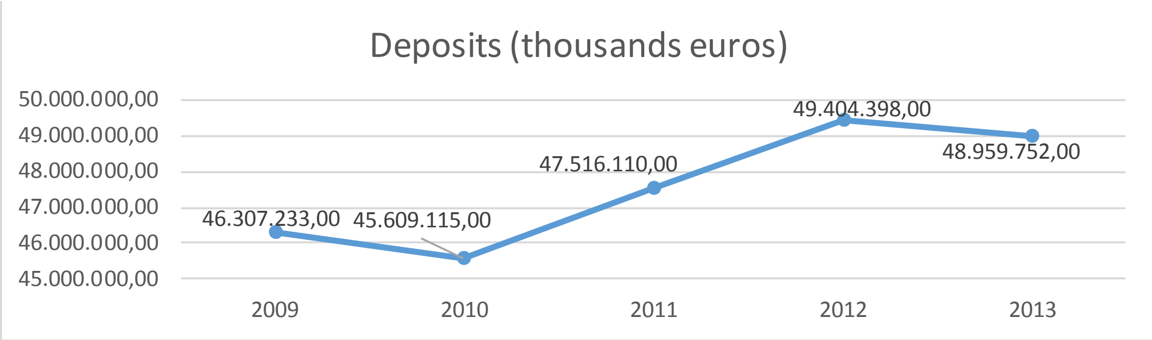
Appendix 17: BCP's deposits



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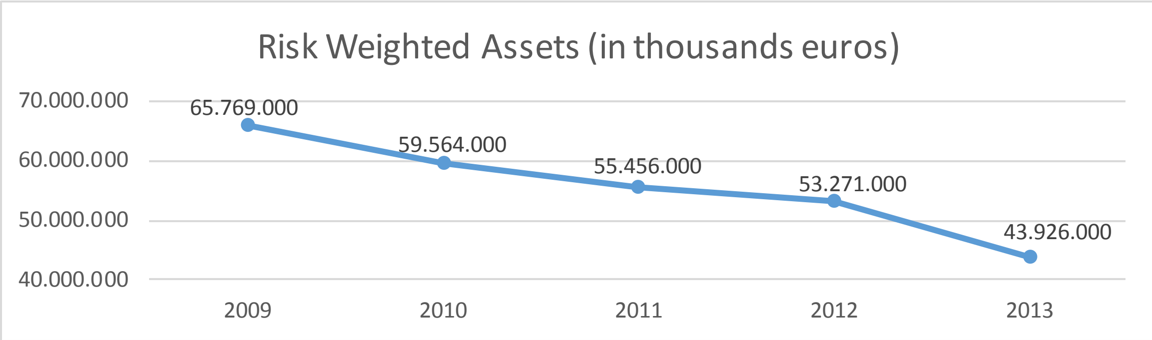
Appendix 18: BCP's loan portfolio (in thousands euros)

	2010	2011	2012
Mortgages	**31,036,000**	**30,303,000**	**29,509,000**
Activity in Portugal	22,553,000	21,768,000	20,669,000
International Activity	8,503,000	8,540,000	8,840,000
Consumer Credits	**4,846,000**	**4,497,000**	**4,247,000**
Activity in Portugal	2,922,000	2,689,000	2,469,000
International Activity	1,924,000	1,808,000	1,778,000
Companies	**40,529,000**	**36,728,000**	**33,105,000**
Activity in Portugal	33,461,000	30,094,000	26,443,000
International Activity	7,068,000	6,634,000	6,662,000
Loans and advances to customers	**76,411,000**	**71,533,000**	**66,861,000**
Activity in Portugal	58,917,000	54,552,000	49,581,000
International Activity	17,494,000	16,981,000	17,280,000

Source: Own source adapted from Banco Commercial Português. 2011. "Annual Report 2010". , Banco Commercial Português. 2012. "Annual Report 2011". , Banco Commercial Português. 2013. "Annual Report 2012". , Banco Commercial Português. 2014. "Annual Report 2013".

Appendix 19: BCP's risk weighted assets



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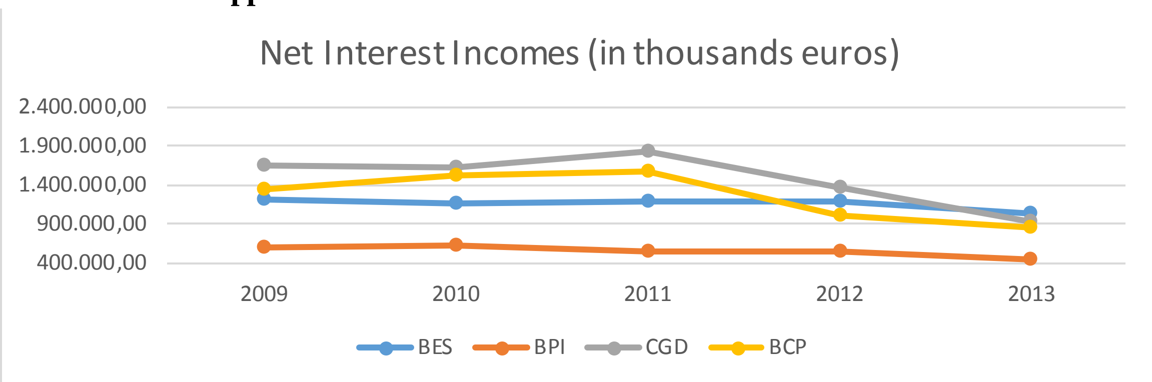
Appendix 20: Net Interest Incomes of the four banks



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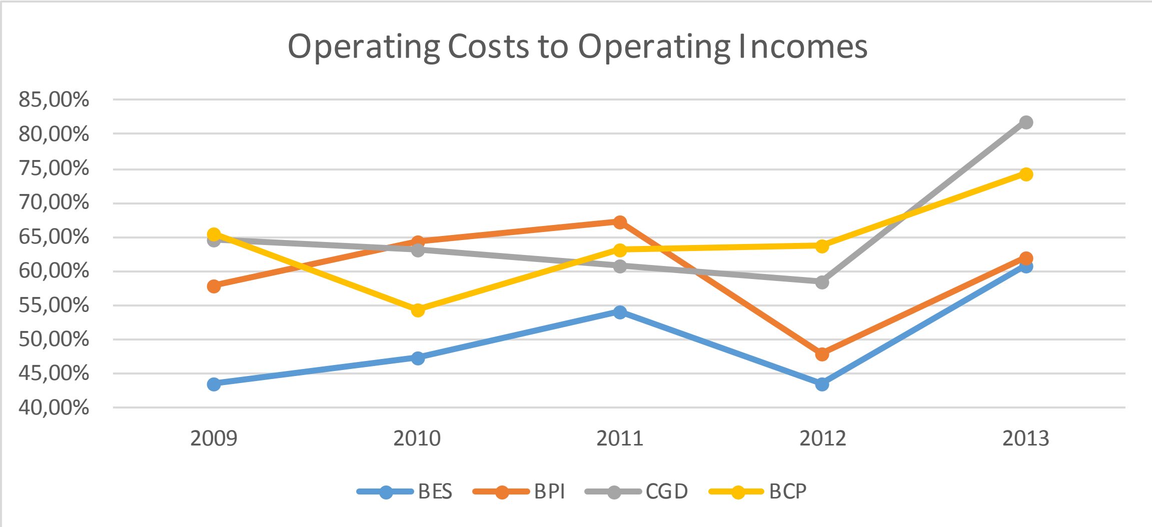
Appendix 21: Operating Costs to Operating Incomes



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